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Supreme Court of the United States

October Term, 1944.

No. 720.

F. G. BADENHAUSEN, WILLIAM S. SPATCHER and HOWARD H. HUBBARD, constituting the Protective Committee for the Holders of Georgia and Alabama Railway First Mortgage Consolidated Five Per Cent. Gold Bonds, Due 1945,

Petitioners and Appellants Below,

AGAINST

GUARANTY TRUST COMPANY OF NEW YORK and MERREL P. CALLAWAY, as Trustees of Seaboard Air Line Railway Company First and Consolidated Mortgage, dated September 1, 1915; *et al.*,

Respondents and Appellees Below.

—o—

Guaranty Trust Company of New York and Merrel P. Callaway, as Trustees, et al., Complainants v. *Seaboard Air Line Railway Company, et al., Defendants,* Consolidated Cause. In Equity No. 214. And in the constituent causes numbered 213, 214, 228, 229, 172, 173, 174, 237 and 238 of said consolidated cause.

Reply Brief of Petitioners F. G. Badenhausen, et al., Constituting the Protective Committee for the Holders of Georgia and Alabama Railway First Mortgage Consolidated Five Per Cent. Gold Bonds.

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Reply Brief of Petitioners F. G. Badenhausen, et al., Constituting the Protective Committee for the Holders of Georgia and Alabama Railway First Mortgage Consolidated Five Per Cent. Gold Bonds.

Statement of Facts.

Before replying to certain of the points raised by the respondents' brief, petitioners find it necessary to refute certain factual assertions and inferences made by the re-

spondents in their brief, pages 5-8, to the effect that the petition contained certain mis-statements of fact which are numerically alleged. It hardly seems the function of briefs to argue disputed questions of fact but respondents' assertions challenge, in effect, the integrity of petitioners, and render it necessary to reply as briefly as possible thereto.*

1. Respondents deny that the Compromise Committee purported to act in a *judicial* capacity. However, the fact remains that the manner in which the Committee functioned, and the duties and powers it assumed, clearly indicate that they considered themselves as acting in a *judicial* capacity.

The District Court, when it appointed the Committee, designated it as a "Compromise Committee" not as a Conference Committee. The Committee's Report is entitled "Compromise Committee, Exhibit 1". The Compromise Committee's Report (R. Vol. I, p. 415) states:

> "The members of your Committee, in response to their appointment by your Honors, have considered themselves to be in the position of officers of the Courts charged with the responsibility of exercising *impartially informed judgments* based upon the many considerations and factors developed in the large and comprehensive record of these proceedings during its long course before the Special Master." * * * (Italics ours.)

(p. 417):

> "Your Committee has attempted in the Compromise proposal to give effect to the principles laid down by the United States Supreme Court particularly within the past few months, and to fit into the hierarchy of the new capital structure the contributions of the separate divisional and system

*Petitioners follow respondents numerical order.

mortgages and leased lines in such a way that each will retain in relation to the other relatively the same position as to earnings that it formerly had, and to grant to each such interest new securities which are the equitable equivalent of the rights represented by the securities and claims to be surrendered in order that the full priority rule of the *Boyd* case as applied to the rights of creditors *inter se* may be satisfied."

It appears perfectly obvious that the Committee assumed duties and powers far greater than those originally indicated when it was appointed by the District Court. The function of the Committee, as outlined by the District Court at the time it was appointed, was to negotiate a compromise wherein all participating parties were to agree to its terms. This is distinctly set forth in the record. There was no reason for the Compromise Committee to *hear* anyone. They had participated actively in all of the hearings before the District Court and knew perfectly well the claims of each of the participating parties. Their true function, which was never truly exercised, was to negotiate a Compromise between all of the interested parties. The Committee has repeatedly stated that, in reaching its results, it exercised an *impartially informed judgment*. The fact is that the Compromise Committee not only purported to but actually did assume to act in a judicial capacity. The very language used as well as the powers assumed indicate as much. That they subsequently refer to themselves as a "Conference Committee" does not change the facts. Although the Committee's Report mentioned certain general principles which purportedly guided their judgment, they have never explained in their Report, or in open court, the methods by which they obtained their results, nor did they consistently follow the principles which they stated they recognized. For in-

stance, the Committee stated in its Report (R. Vol. I, p. 419) that it recognized—

> "the fundamental principle of fairness and equity in providing for distribution of abnormal war earnings to holders of securities whose properties have produced such earnings."

The abnormal war earnings in this case were in excess of $34,000,000 but the Tertiary Allocation recommended by the Committee, which purported to distribute these abnormal war earnings to holders of securities whose properties have produced such earnings, only distributed on that basis, according to the respondents' own version, approximately $12,000,000, or about one-third of the abnormal war earnings.

2. The respondents deny that the securities allocated to the Georgia and Alabama Bonds were valued at certain specified amounts. They assert that no dollar values were assigned by the District Court to any of the new securities. Respondents infer that the alleged values used in the brief of the petitioners were "a guess", not based on any evidence in the record or upon any findings made by the Special Master or the District Court. Respondents omit to mention that when the Special Master sought to compensate the senior liens, in cases where a portion of the value of the property subject to the senior liens was allocated to holders of junior liens secured on the same property, he did so by using a valuation of $1,000.00 for each $1,000.00 First Mortgage Bond, $500.00 for each $1,000.00 Income Bond, $25.00 for each $100.00 share of Preferred Stock and $12.50 for each share of Common Stock and that this procedure was approved by the District Court. If this base was fair and sound for the aforesaid purpose, it is equally sound for estimating the valuation of all the securities allocated to the Georgia and Alabama

Bonds. It is true that the estimated value of these securities made by the Special Master cannot be accurate and depends upon the market value of the securities which, of course, fluctuates, but in any event it represents a close approximation and the valuation which the Special Master fixed in his own mind as to the securities awarded and hence as to the final valuation of each of the Mortgage Divisions.

3. Respondents question the fact asserted in the petition that the huge wartime earnings were due mostly to traffic contributed by the various Underlying Divisional Lines, and that all the Underlying Divisional Lines were earning huge sums during the years 1942 and 1943, particularly those lines which were denoted as "deficit" lines. They state that there is no evidence to support this statement. The record, however, speaks for itself. Aside from the fact that the General Mortgages constituted Secondary Mortgages on all of the Underlying Divisions, and in minor instances First Mortgage liens on certain lines, the bulk of the equity of the General Mortgages lie in their lien on certain funds or securities and properties owned by the Seaboard System, in addition to their lien on the equipment owned by the System. The rents and interest charges earned by the equipment and properties on which the General Mortgages have a first lien remain practically constant, irrespective of the amount of business or traffic carried by the System. On the other hand, the Underlying Divisional Lines, which carry most of the traffic of the System, are the backbone or heart of the System and immediately reflect and show an increase in earnings as the traffic is increased. It necessarily follows that as the wartime traffic increases the wartime earnings of these divisions increases proportionately, the increase in earnings therefore must be due entirely to the various Underlying Divisional Lines.

Contrary to the respondents' assertion, the record (R. Vol. I, 158-163, 211-213) clearly shows that the "deficit" lines showed an increase in earnings during the war years *relatively* much greater than that shown by the lines which had been profitable prior to the war. This was clearly illustrated by the expert Wyer's testimony (R. Vol. I, pp. 211-213, 158-163) and by his Court Exhibits Nos. 1 and 2 (R. Vol. 1, pp. 409, 410). It is a natural phenomenon of all railroads that, as the business of the railroad increases, not only do the earnings increase proportionately, but the overhead decreases inversely. The "deficit" lines, mathematically, must show a greater relative increase than the lines which had been profitable previously since the cost of the "earning" divisions was always maintained at a low level. Wyer's testimony and Court Exhibits 1 and 2, which were not refuted, clearly prove that the increase in earnings of any "deficit" line during the war years must relatively be much greater than any of the so-called prewar "earning" Divisions.

4. Respondents deny petitioners' assertions that the Underlying Bondholders Committee "favored the so-called 'earning Divisions' represented by it", and for all practical purposes abandoned the true representation of the so-called "deficit Divisions". To support that denial respondents make the assertion that every argument or contention made by these petitioners in the District Court was also made by the Underlying Committee on behalf of the Georgia and Alabama and other deficit lines. Nothing could be further from the truth.

During the course of the reorganization hearings, petitioners filed a petition in the District Court for an order directing the Underlying Bondholders Committee, who purported to represent ten of the Underlying Divisions, to cease to represent Georgia and Alabama Division, on the ground that there was a conflict of interest. The

hearing on this petition was deferred by the District Court until after the reorganization hearings. The answer of the Underlying Committee *admitted* that there was a conflict of interest between the various issues of Underlying Bonds as to the Plan of Reorganization to be adopted, but sought to justify their position on the ground that there were many mutual interests and advantages to be gained by presenting a united front. Mr. Baetjer, chairman of the Underlying Committee, who testified, admitted that a conflict of interest existed between the various Mortgage Divisions the moment there was a limited common fund to be divided among them. Mr. Baetjer testified at this hearing that he contemplated making all of the good bonds whole but was *prepared to make some concessions for three poor issues.* He further testified that he considered the Georgia and Alabama one of the three poor issues, which would not receive full payment of their claim. The record and final allocations recommended by the Compromise Committee clearly disclose that all of the so-called Underlying "earning" divisions benefited far more greatly than the so-called "deficit" lines, by reason of the Compromise recommended by the Committee. As stated by the District Court (R. Vol. I, 116-117) the *principal objection* of the Underlying Committee was in the treatment of deficits, which affected only the so-called *"earning"* divisions. It is clear therefore that the Underlying Committee *did favor* the so-called "earning" divisions represented by it.

It is true that several of the contentions advanced by petitioners were also made by the Underlying Committee but it is likewise true that many of the arguments made by the petitioners were not made by the Underlying Committee. Counsel for petitioners attacked both the Secondary and Tertiary Allocations of wartime earnings. Petitioners actively contended that the Kennedy Segregation Formula adopted was inequitable and unfair and

exposed the fallacies and defects of the adopted Segregation Formula. Counsel for petitioners alone stressed the amount of salvage value of the Georgia and Alabama Railway, which the Receivers stated amounted to $1,200,000 and counsel for petitioners alone stressed the enormous contribution made by the Georgia and Alabama Railway to the freight revenue of the entire system which, during the average year 1936-1940, amounted to $1,945,365. Counsel for petitioners alone demonstrated that even in 1939, when under the Kennedy Segregation Formula the Georgia and Alabama Railway purportedly had a deficit of $221,000, the Georgia and Alabama Railway contributed net freight revenue to the balance of the system $922,567. It will be seen from the foregoing that the statements made by the respondents are distorted and inaccurate.

5. Respondents take issue with petitioners' statement that the Tertiary Allocation "applied to only a small portion of the new securities released". Respondents assert that the Tertiary Allocation actually disposed of approximately $12,000,000 in cash and securities of the wartime earnings. It will be recalled that the wartime earnings and securities released by wartime earnings were in excess of $34,000,000.

It must be admitted that the facts with respect to the amount of securities involved in the Tertiary Allocation are not at all clear from the Court record and exhibits. The Court record, with the exception of the District Court Opinion, contains nowhere any direct or indirect statement as to the amount of securities involved in the Tertiary Allocation. In addition, the proceedings of the Compromise Committee were kept highly secretive. No indication was given by the Compromise Committee as to what the recommended modifications would be until the very day set for the hearing to approve the Plan of Reorganization, as modified by the Compromise Committee.

The statement made however by the petitioners as to the amount of securities involved in the Tertiary Allocation was not an arbitrary guess on their part but was predicated, as stated on page 37 of their brief, on the facts stated by Judge Chesnut in his opinion (R. Vol. I, p. 125), which describes the Tertiary Allocation as applying only to a small amount of securities released by the cash provisions made for the acquisition of Tampa Northern and Georgia, Florida & Alabama Bonds. Assuming that the District Court was in error and that the respondents' version is correct, it still appears that the Tertiary Allocation applied to approximately only one-third of all the securities and cash acquired by the wartime earnings. It also appears that the Compromise Committee has not followed the fundamental principle advocated by it in its Report (R. Vol. I, p. 419), to wit, "the principle of fairness and equity in providing for distribution of abnormal war earnings to holders of securities whose properties have produced such earnings". It still appears that the balance of the wartime earnings, approximately two-thirds thereof, is distributed (pursuant to the Secondary Allocation) on a pre-war basis only among such Divisions as showed earnings during the period 1936 to 1940. Mortgage Divisions, such as the Georgia and Alabama Railway, which have had large earnings during the wartime period and which have contributed heavily to these cash purchases, receive no part of the balance of these securities since they showed no segregated earnings in the period 1936 to 1940 under the Segregation Formula adopted.

Replying to Point I of Respondents' Brief.

Respondents contend that there is no conflict between the decision of the Circuit Court of Appeals in this case and the Circuit Court of Appeals for the Second Circuit in the *"Rutland"* case.

Respondents distinguish the *"Seaboard"* case from the *"Rutland"* case on the ground that the Seaboard Receivership had begun *before* the enactment of Section 77, whereas the Rutland Receivership had been begun *after* the enactment of Section 77.

Respondents state that the institution of the Seaboard Receivership in 1930 could not have been a violation of any congressional policy announced in 1933, when Section 77 was enacted.

But the issue here is not the institution of the Receivership—it is the *reorganization* of the railroad. In both cases the reorganization proceeded long after the enactment of Section 77. In the *"Seaboard"* case the proceedings to reorganize in the District Court were commenced in 1939—six years after the enactment of Section 77.

The District Court herein, in its opinion (R. Vol. I, p. 142) admitted that the primary reason which prompted the enactment of Sections 77 and 77b of the Bankruptcy Act was that equity procedure in corporate reorganizations had heretofore in many cases proved unsatisfactory. Nevertheless the Court proceeded to reorganize in equity receivership.

It is self-evident that the principles enunciated by the Circuit Court of Appeals for the Second Circuit are equally applicable to the instant case, when the reorganization began long after the passage of Section 77.

That the existing conflict in the law is confusing to other courts is clearly indicated in the case of the Wisconsin Central Railway. The Wisconsin Central Railway was in receivership since December, 1932, *before* the enactment of Section 77. Proceedings to reorganize were commenced in equity, and were pending, the situation being very similar to that of the *"Seaboard"* case. Thereafter the *"Rutland"* case was decided by the Circuit Court of Appeals for the Second Circuit. According to published reports, petitioners understand this decision influenced the District Court to place the Wisconsin Central Railway

in bankruptcy and to proceed in bankruptcy with the reorganization of the railroad.

It is clear that this conflict and the important question of law raised thereby should be finally and authoritatively settled by this Court.

Replying to Point II of Respondents' Brief.

Respondents on pages 9 and 10 and Point II of their brief contend that "petitioners did not object in the District Court proceedings to the appointment of the Committee or to the membership of the Committee, nor did they raise any question as to the propriety of the appointment of the Committee or its membership in their appeal to the Circuit Court of Appeals. They have waived any right to object at this stage of the proceedings".

If the facts asserted by respondents were true or fully disclosed, their contention may be sound, but the facts are not true nor fully disclosed.

Respondents infer that petitioners did not raise before the Circuit Court of Appeals the objection to the Compromise Committee and its recommendations that it now raises before this Court. Nothing could be further from the truth.

Petitioners in Point 8 of their brief before the Circuit Court of Appeals raised exactly the same contentions that they now urge in Point 2 of their brief in support of their petition for a writ of certiorari. In fact, the language used in Point 8 of petitioners' brief before the Circuit Court of Appeals, except for minor changes, is identical, word for word, with that used in Point 2 of petitioners' brief before this Court.

If respondents admit that the petitioners' brief now raises serious objections and questions with respect to the Compromise Committee, they must also admit that the same objections were raised before the Circuit Court of Appeals.

Respondents also assert that at the time when the Compromise Committee was appointed, the petitioners did not object to the Committee or to its membership. This fact is true, but all of the facts are not being fully disclosed.

Before the District Court appointed a Compromise Committee, the Court discussed the practical business aspect of deciding the issues before the Court on a compromise basis rather than on a legal or judicial basis, in order to expedite the reorganization at the time when the earnings of the System were at the highest level (R. Vol. I, pp. 365, 368). The District Court urged that all of the active participating parties try to come to a definite *agreement by consent* as to a Plan of Reorganization so that the Court could confirm the Plan with the modifications agreed upon by the parties (Ct. Tr. pp. 1351, 1354, 1369, 1370).* At the time the District Court discussed compromise the Court also rendered its tentative opinion and specifically stated in such opinion that the Georgia and Alabama Division was being unfairly treated under the proposed Plan of Reorganization (R. Vol. I, p. 360). Counsel for petitioners was specifically asked, at the time compromise was discussed by the Court, whether he would be willing to agree to compromise, to which he replied in the affirmative.

Mr. Sunderland, who was subsequently appointed Chairman of the Compromise Committee and who represented the Trustees of the System's largest general mortgage, in suggesting the appointment of a Compromise Committee, and stressing the advantages to be gained thereby, stated that the objective was to make an *agreement to agree* on the various issues between the interested participating parties (Ct. Tr. p. 1332). The District Court, in discussing the compromise, specifically stated:

*The Court Transcript pertaining to the Compromise is not contained in the printed record on appeal. However, the original record of the Court Transcript has been certified and is on file in the Clerk's Office of this Court and available for examination.

"The Court: What I want to ask you gentlemen is this: Mr. France and Mr. Andrews and to the extent Mr. Sunderland feels interested and the others are interested, decide these two outstanding questions and if you can't decide them any other way, divide them in half. That ends that dispute and it is the major dispute in the whole case. You and Mr. Andrews and Mr. Sunderland or somebody else get together on one side of the table and deal with these individual roads that seem to think they have been unfairly treated and say what you will each give up to them in addition to what they have. If you do that you end the problems, you agree upon your plan. There are some minor things that would still have to be ironed out. I have got to decide this question of law about the preferred stock of the Seaboard & Roanoke. That is a pure question of law. I can certainly do that in a few days. I will undertake that trouble and have that question decided in probably two or three days after I get the briefs of counsel. In the Georgia & Alabama there is the contention that they are not fairly treated for the reasons indicated. Mr. France on one side of the table and Mr. Andrews and Mr. Sunderland on the other can deal with Mr. Mitnovitz, assisted by the friendly counsel of Mr. Rothchild and say what both of you are willing to give up in view of their situation. The same way with the Atlanta-Birmingham. I don't see any reason why people who have their main eye on getting through with it should not agree in a couple of hours" (Ct. Tr. pp. 1369-1370).

It clearly appears from the record, the District Court suggested that a Compromise Committee be appointed to negotiate with the interested parties whose rights appear to be adversely affected by the Master's Plan, so that a Plan of Reorganization be confirmed which would be

agreeable *by consent*, to all interested participating parties (Ct. Tr. pp. 1314-1386).[1]

The fact that the Compromise Committee was composed of partial major interests was of no importance, if all of the parties were to agree and compromise their differences. In fact, it was necessary to have the major interests approve any compromise, before it could become effective. No reason existed for the petitioners to object to the Committee or its membership if the procedure outlined by the District Court was followed. However, the procedure outlined by the District Court was never followed. The Compromise Committee assumed and purported to act in a judicial capacity. It never attempted to negotiate or discuss terms of compromise with the petitioners. The Committee merely asked petitioners to express their views as to the terms of compromise.

After the Compromise Committee submitted its Report and made its recommendations, petitioners did object to the procedure and methods used by the Compromise Committee, and stated that it had never consented to the proposed modifications. This statement appears in the Transcript of the Court Record, pages 1495 to 1501, which is on file in this Court. Petitioners admit that it is a proper and useful function in reorganization to compromise differences in order to avoid unnecessary litigation, but a compromise is necessarily based upon mutual consent of interested parties. The difficulty in the instant case is that the word "compromise" has been used promiscuously but the sense of the word has never been observed.

Replying to Point III of Respondents' Brief.

Respondents assert that no questions of "compensation" to the Georgia and Alabama Bonds arises in this

1. The Court Transcript pertaining to the Compromise is not contained in the printed record on appeal. However, the original record of the Court Transcript has been certified and is on file in the Clerk's Office of this Court, and available for examination.

case. Respondents assert that a senior creditor is entitled to compensation for the loss of senior rights if he is required to take inferior securities, but only if junior securities were also allowed to participate. However, in the *"Milwaukee"* case, this Court held that in a railroad reorganization, the true principle is that each divisional mortgage must receive sufficient securities in the new corporation, so that each will retain, in relation to the other divisional mortgages, the same position it formerly had in respect to assets and of earnings at various levels.

Can it be fairly said, in view of the securities which the Georgia and Alabama Railway receives under the Plan of Reorganization, that the Georgia and Alabama Division retains, in relation to the other Mortgage Divisions, the same position it formerly had in respect to assets and of earnings, paricularly when it was a first mortgage on 393 miles of railroad which earned in 1942, even under the Kennedy Segregation Formula (which petitioners contend is unfair and erroneous) over $1,016,937? Under the Plan of Reorganization the Georgia and Alabama Railway receives First Mortgage Bonds in the sum of $357,408; Income Mortgage Bonds in the sum of $1,597,627; Preferred Stock in the sum of $656,461 and Common Stock in the sum of $3,739,875. On the valuation set for these securities by the Special Master, the Georgia and Alabama received securities valued at $1,805,880.00.

The Master's Report, Exhibit A (R. Vol. II) clearly shows that the Georgia and Alabama Division contributed to the balance of the System on freight contributions during the average year 1936-1940, $1,945,365. Even in 1939, when under the Kennedy Segregation Formula, the Georgia and Alabama Railway purportedly had a deficit in the sum of $221,000, the Georgia and Alabama Railway contributed in net freight revenue to the balance of the System $922,567 (R. Vol. I, S. M. Exhibit, 415, p. 591).

It is clear that the Georgia and Alabama Railway earned, even under the Kennedy Formula, in 1943, and in the year 1944, the same amount, if not more than, it earned in 1942. Mr. Wyer testified that he estimated the earnings of the Georgia and Alabama Railway in 1943 to be anywhere between $1,500,000 and $2,000,000 (R. Vol. I, 160-161). In addition, petitioners have clearly shown that the net salvage value or junk value of the Georgia and Alabama Railway and its terminal, lands and buildings, *excluding* rights of way, amounts to $1,200,000. The record clearly discloses that the Special Master, in estimating the value and earnings of the Georgia and Alabama Railway, failed to give any consideration whatever to the earnings of the Georgia and Alabama Railway during the years 1941, 1942 and 1943.

It is perfectly obvious that if the present Plan of Reorganization is approved, the Georgia and Alabama Division by no means retains, in relation to the other Mortgage Divisions, the same position it formerly had in respect of assets and of earnings, particularly when the bulk of the securities received (which are inadequate in the first instance) are inferior securities of junior grade.

It is therefore respectfully submitted that this case is one calling for the exercise by this Court of its supervisory powers, by granting a writ of certiorari and thereafter reviewing and reversing said decision.

Respectfully submitted,

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